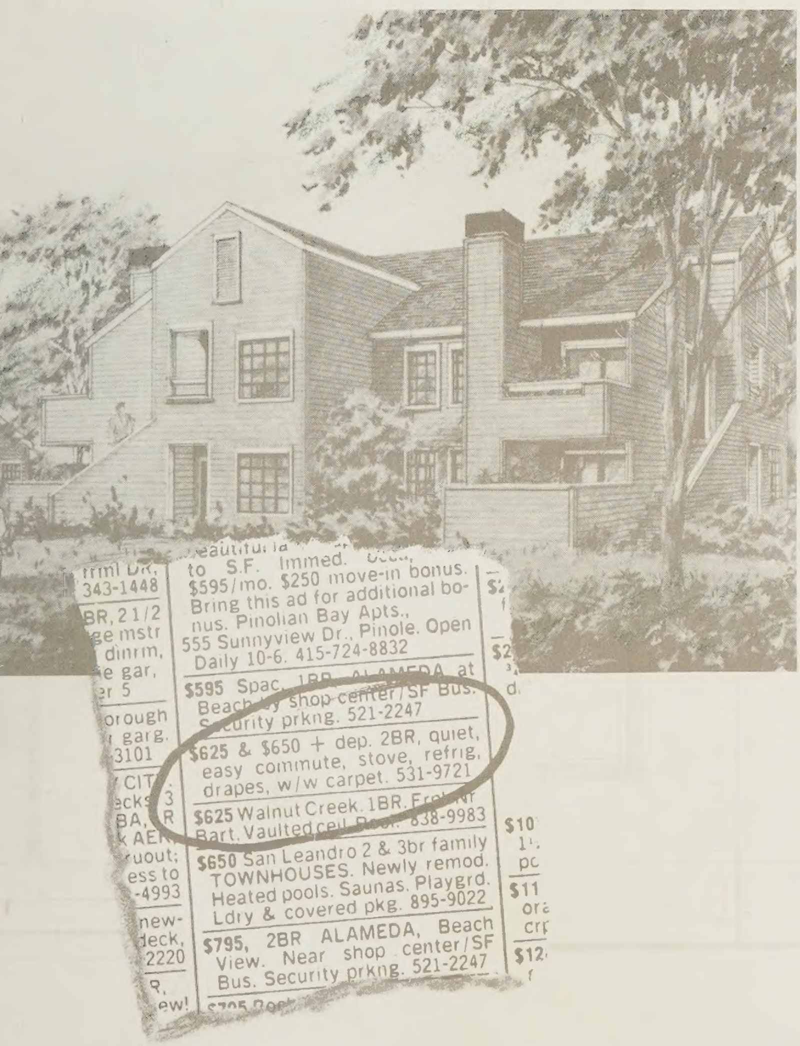
# BAY AREA RENTAL HOUSING:

## *Will The Boom Continue?*






BAY AREA COUNCIL

# BAY AREA COUNCIL

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April 23, 1987

Dear Bay Area Housing Briefs Subscriber:

Enclosed you will find your complimentary copy of the Bay Area Council's 1987 rental housing study. It contains unique information on rental housing production and affordability in the Bay Area, as well as an analysis of the current and future state of the rental housing market. I trust you will find it both interesting and useful.

This is the Bay Area Council's third major study on the rental housing market. In the coming year, our research will continue with the monthly data inserts of Housing Briefs, as well as other special studies on housing issues of regional importance. As always, we appreciate your comments and reactions to our work.

Sincerely,

Thomas Cook

Thomas Cook
Housing Associate

# OVERVIEW OF FINDINGS

A rare convergence of factors has led to a three-year surge in the production of rental housing in the Bay Area. The boom that began in 1984 gained momentum in 1985 and, though it appears to have slowed somewhat, has continued through 1986 and into 1987. The jurisdictions sampled by the Council issued permits for more rental housing units in 1985 than in any year during the past decade. As a result of strong rental housing production, vacancy rates have increased and rents have levelled off in the past two years.

Factors behind the surge in production include:

- **Strong demand for rental housing,** bolstered by years of low production levels and economic conditions that kept many renters from making the leap to homeownership, as well as rapid employment growth in some areas.
- **An upswing in rents** between 1982 and 1984, after nearly a decade in which rents lagged behind inflation.
- **Lower and relatively stable interest rates,** along with the availability of tax-exempt revenue bonds.
- **Changes in the investment climate** and federal tax laws which created incentives for investment in rental housing.
- **Local government actions** to encourage rental housing through tax-exempt bond financing and land-use decisions.

A number of these factors are already changing. Flat rents and tax reform are resulting in tighter project economics, and greater uncertainty in the climate for investment in rental housing. Strict new limits on tax-exempt bond authority and difficulties obtaining conventional financing are leading developers to seek other sources of funding.

The evidence suggests that rental housing production will continue in the near term, though at a somewhat slower rate than in the past two years. The demand for rental housing is likely to weaken somewhat, though employment growth will continue to fuel strong demand for rental housing in some suburban areas. Rents are likely to remain flat in the foreseeable future.

At the same time, federal and state government cutbacks, tax reform and the economics of rental housing will mean less production targeted to low- and moderate-income households. Affordability problems have worsened in the '80s, despite the production boom and the levelling-off of rents in the past two years. While the outlook for the Bay Area rental market is relatively positive on the whole, the prognosis for development of affordable units is not encouraging.

For the private sector, the challenge will be to identify the best markets for rental housing, and manage project feasibility carefully. For affordable housing advocates, the task will be to find new ways to work with local government, non-profit, and for-profit developers toward increased production of affordable rental housing.

*In the last three years, the Bay Area has seen a rental housing boom—but that doesn't mean our problems are solved. While the region catches up with rental housing needs, affordability is getting worse. Meanwhile, the climate for production is already in flux....*

Table 1
**Rental Housing Permits & Approvals**

| County/Cities | Permits 1984 | 1985 | 1986 Jan-Jun | Pipeline Approved as of 6/30/86 |
|---|---|---|---|---|
| Alameda | 1,288 | 585 | 1,194 | 2,393 |
| Dublin | 555 | 0 | 0 | 0 |
| Livermore | 162 | 162 | 232 | 167 |
| Oakland | 164[a] | 329 | 432 | 1,405[d] |
| Pleasanton | 379 | 40 | 284 | 659 |
| Uninc. | 28 | 54 | 246 | 162 |
| Contra Costa | 2,453 | 2,445 | 1,490 | 3,581 |
| Concord | 250 | 542 | 300 | 0 |
| Pittsburg | 208 | 977 | 590 | 264 |
| San Ramon | N/A | 0 | 0 | 0 |
| Walnut Creek | 42 | 180 | 0 | 583 |
| Richmond | 221 | 387 | 30 | 1,508 |
| Uninc. | 1,732 | 359 | 570 | 1,226 |
| Marin | 28 | 98 | 42 | 88 |
| San Rafael | 28 | 98 | 17 | 17 |
| Uninc. | 0 | 0 | 25 | 71 |
| Napa | 41 | 337 | 0 | 103 |
| Napa | 17 | 337 | N/A | 103 |
| Uninc. | 24 | 0 | 0 | 0 |
| San Francisco | 129[b] | 979 | 329 | 319 |
| San Mateo | 11 | 92 | 68 | 49 |
| San Mateo | 0 | 92 | 0 | 49 |
| Uninc. | 11 | 0 | 68 | 0 |
| Santa Clara | 1,609 | 2,440 | 1,223 | 1,051 |
| Palo Alto | 92 | 99 | 40 | 66 |
| San Jose[c] | 767 | 496 | 288 | N/A |
| Santa Clara | 14 | 588 | 611 | 885 |
| Sunnyvale | 736 | 1,257 | 284 | 100 |
| Uninc. | 0 | 0 | 0 | 0 |
| Solano | 36 | 2,885 | 534 | 650 |
| Vacaville | 0 | 1,945 | 194 | 650 |
| Vallejo | 36 | 940 | 340 | N/A |
| Uninc. | 0 | 0 | 0 | 0 |
| Sonoma | 1,393 | 2,118 | 345 | 1,601 |
| Rohnert Park | 222 | 810 | 160 | 739 |
| Santa Rosa | 1,171 | 1,252 | 178 | 862 |
| Uninc. | 0 | 56 | 7 | 0 |
| All Jurisdictions | 6,988 | 11,979 | 5,225 | 9,835 |

*N/A = not available*
*a) subsidized units only*
*b) bond-financed units only*
*c) rental projects with underlying condominium maps not included*
*d) includes proposed projects*

*Source: Bay Area Council*

# DYNAMICS OF THE CURRENT TREND

## A Continuing Production Surge

As documented by the Council's updated survey of local jurisdictions, the rental housing boom that started in 1984, and picked up speed in 1985, has continued through 1986—though at a somewhat slower pace.

The Council surveyed planning and building departments in 29 local jurisdictions in the nine-county Bay Area. Units were categorized as rental if they were financed through a tax-exempt bond (and thus required by law to be rental), or designated for rental by a development agreement, or developed with an underlying condo map (thus indicating initial use as rental housing), or specifically identified by the developer as rental units.

The 29 jurisdictions reported issuing permits for a total of 11,979 units of rental housing during 1985, 71 percent more than were issued by the same jurisdictions in 1984. The reporting local governments issued permits for 5,225 rental units in the first six months of 1986. If permit activity continued at the same pace through the last half of the year, the number of new rental units permitted in 1986 would have been 26 percent less than in 1985—though still 50 percent higher than activity in 1984. (*See Table* 1.)

A look at the data by jurisdiction shows that the 1985 boom was widespread; most of the jurisdictions reported issuing more rental permits in 1985 than in 1984. Production was strongest in Santa Clara, Contra Costa, Solano, and Sonoma Counties. Only Marin and San Mateo Counties failed to show a significant upswing.

In 1986 rental production remained strong regionwide, but with greater variations among subregional markets. Some market areas—such as Santa Rosa, Sunnyvale, and Vacaville—saw significant declines in rental permit activity. Others—such as Oakland, Pleasanton, Livermore, and Santa Clara—saw production rates continue to rise in the first half of 1986.

Findings of an upswing in rental housing production in the mid-'80s are confirmed by available data for multi-family building permits. According to statistics gathered by the U.S. Census and released by Security Pacific National Bank and the Construction Industry Research Board, in 1986 permits for 24,324 multi-family units were issued, making that the Bay Area's best year for multi-family housing since 1970. In the last three years, multi-family housing has represented more than half of all housing construction. In previous years, multi-family housing rarely accounted for more than a third of residential building permits issued. (*See Figure 2 on page* 4.)

## More Supply Brings Good News for Renters

Since 1985, the rise in rental production has had clear impacts on the market for rental housing. Though the Bay Area's rental market remains tight compared to other regions in the nation, vacancy rates have risen somewhat. According to the Federal Home Loan Bank of San Francisco, Bay Area multi-family vacancy rates stood at 1.3 percent in the fall of 1984, but rose to 2.3 percent just one year later. Full 1986 data has not yet been released, but indications are that the vacancy rate has continued to increase.

More important from the renter's standpoint, rents have levelled off with the surge in production in the last two years. According to the Bay Area Council's quarterly survey of advertised rents in six major markets within the Bay Area, the median advertised rent for a two-bedroom apartment jumped 75 percent (from $395 to $695) between 1980 and January 1985. But in October 1986, the median advertised rent was $700, virtually unchanged since almost two years before (*see Figure* 1).

The flattening of rents is a bright spot in the affordability picture, but also raises questions about the attractiveness of rental housing development in the future. From the early '70s until 1981, rent levels actually declined relative to inflation—one of the major reasons for the slump in apartment production. In 1982, rents began rising faster than inflation, which was a critical factor in the feasibility of new rental projects. At least in the near term, the shift back to flat rents will be a significant factor in the economics of rental housing projects.

## Overall, Worsening Affordability

While stable rents have brought some relief from spiralling rental costs in the last two years, housing affordability has generally worsened since 1980. In 1980, 41 percent of all renter households in the Bay Area were already paying more than 30 percent of their incomes toward rent, and in the last five years rents have outpaced gains in income. According to the Council's survey, advertised rents climbed 75 percent between 1980 and 1986. Incomes in the Bay Area, however, rose only 40 percent in the same period, according to estimates by Urban Decision Systems.

In 1980, the median income for renter households in the Bay Area was $13,839; it required 34 percent of that income to pay the median advertised rent of $395 for a two-bedroom unit. Today, median household income for renters is estimated at $19,303, 44 percent of which would be required to rent the median two-bedroom apartment ($700 per month). In some subregions the income requirement is even higher (*see Table 2 on page* 4).

It is important to note that despite the expansion of rental housing stock, no widespread decline in rents has yet been observed. At the same time, rents on newly constructed apartments are beyond the reach of the average renter household. To pencil out, most new projects require rent levels of $800 to $1,000 a month or more. In San Francisco and other areas where land costs are high, developers must target new apartments to the most affluent segments of the renter market.

Figure 1
**Median Advertised Rents by Area**


*Data not available for July 1986*

*Source: Bay Area Council*

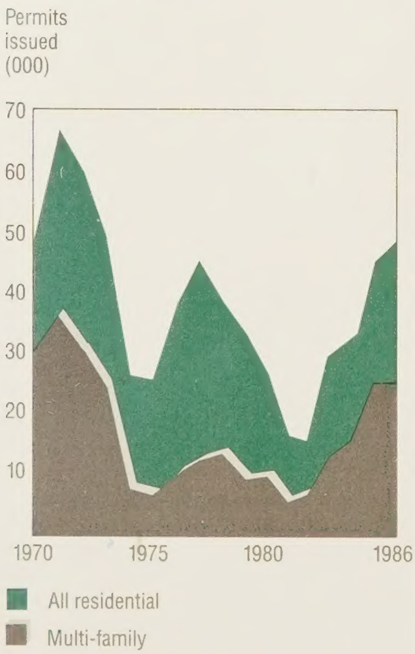
Table 2
**1986 Rental Housing Affordability**

| | Median Household Income | | % of Income Needed |
|---|---|---|---|
| | All HH | Renter HH | for Rent |
| San Francisco | $22,435 | $17,948 | 60% |
| Oakland/ So. Alameda County | 26,002 | 16,901 | 44% |
| Central S. Mateo Co. | 32,483 | 23,063 | 39% |
| Cent. Contra Costa Co. | 32,322 | 19,176 | 39% |
| Palo Alto Area | 33,206 | 22,192 | 38% |
| Marin Co. | 36,182 | 24,242 | 37% |
| S. Rosa Area | 25,034 | 17,274 | 36% |
| S. Jose Area | 33,206 | 22,912 | 34% |
| Regional Average | $28,810 | $19,303 | 44% |

*Median renter income based on percent of total household income as estimated by 1980 U.S. Census, applied to county estimates of 1986 median household income.*

*Sources: Urban Decision Systems; U.S. Bureau of the Census; Bay Area Council*

Figure 2
**Multi-Family vs. All Bay Area Housing Production**




*Sources: Security Pacific National Bank; Construction Industry Research Board*

# FORCES BEHIND THE TRENDS

No single factor explains the region's boom in rental housing. Rather, the dramatic rise in production has been the result of a rare convergence of conditions in the mid-'80s.

## Strong, Continuing Demand

Demographics—notably the coming of age of the baby boom and post-baby boom generations—have steadily swelled the ranks of Bay Area renters. In the first half of the decade, more than half a million Bay Area residents turned 20, entering the prime age group for household formation. Household growth in the '80s has slowed somewhat from the '70s, but has continued to outpace population growth.

At the same time that demographics fueled the demand for rental housing, high interest rates and high home prices kept many renter households from making the move to ownership housing. This was a national phenomenon; in the early '80s, the U.S. rate of home ownership fell for the first time since World War II.

Coupled with the low level of apartment production in the late '70s and early '80s, these trends created a huge unmet demand for rental housing. By 1984, the Bay Area's multi-family vacancy rate had fallen to 1.3 percent, and advertised rents were increasing at the rate of 17 percent a year.

Some submarkets in particular have seen an extraordinary jump in rental housing demand. The fairly recent trend toward decentralization of economic activity has attracted younger households and singles to suburban communities that were formerly enclaves of single-family ownership housing. Between 1980 and 1985, more than 75 percent of all new jobs and 50 percent of all new office space in the Bay Area were located in suburban communities. Effects of this new rental housing demand can be seen in central Contra Costa County, Sonoma County, the Tri-Valley area, and Silicon Valley.

## Favorable Economic Conditions

By the early '80s, the Bay Area's strong unmet demand for rental housing virtually guaranteed developer and investor interest in apartment production, as long as economic conditions were favorable.

By 1984, the economic components of a boom were also in place. Interest rates dropped by three to four points, and remained stable. As the region came out of the recession of the early '80s, job growth and rising incomes expanded the number of affluent renters. Federal tax incentives for construction of rental housing, passed by Congress in 1981 and 1982, came into play. Not only was investor and lender interest in real estate higher than it had been in some time, market and tax considerations made rental housing among the most attractive of real estate investments.

At the same time, the State of California greatly increased the ceiling to which local governments could issue tax-exempt bonds to finance rental housing. Though the relative importance of tax-exempt bonds in fueling apartment production has been debated, it is clear that a major share of units built since 1984 have been financed with tax-exempt bonds.

Bay Area local governments issued $343 million in multi-family bonds in 1984. The following year, lower market interest rates and continued low vacancy rates combined to make the bonds—which are pegged below market interest rates—even more attractive. In 1985, according to a Bay Area Council survey, almost $1.3 billion in bonds were issued in the region—enough to finance 18,656 units of rental housing. (*See Figure 3.*)

Yet given the strength of the demographic and market trends underlying the rise in production, it is likely that the upswing would have occurred even without the availability of tax-exempt bonds—though the bonds certainly boosted production.

Tax-exempt bonds have been a more critical factor, however, in the production of affordable housing. Before passage of federal tax reform in 1986, federal regulations required that at least 20 percent of the units in bond-financed rental projects be affordable to households earning 80 percent or less of median income in the area. In many projects the proportion was higher, due to stricter local requirements for affordability, local incentives for affordable apartment production, or participation by non-profit housing developers.

As a result, nearly one-fourth (4,477) of all the bond-financed units produced in the region in 1985 were targeted to low- and moderate-income families. The bond program's contribution to affordability is difficult to quantify on a regional basis, but the city of Fremont can provide some indication. Carol Lamont, Fremont's community development coordinator, estimates that for the 552 below-market-rate units developed through city bond issues since 1984, the bond program has meant more than a million dollars in annual rent discounts to eligible tenants.

It should be noted, however, that rents on most of the below-market-rate units financed through the bond program are within reach to only a portion of the eligible population, and few of the units serve very low-income households.

## Local Government Initiative

Providing lower-cost tax-exempt financing isn't the only role local government has played in the upturn of rental housing production. Some communities have deliberately encouraged rental housing development through such actions as general plan amendments, upzonings, and density bonuses.

Jurisdictions including Sunnyvale, Contra Costa County, and the San Francisco Redevelopment Agency have made rental housing a priority in recent years. Concord and Santa Rosa are among other cities that have used land-use authority to promote increased production and affordability of rental housing.

Figure 3
**1985 Tax-Exempt Bond Issues for Multi-Family Housing**


Key
**Amount of issue, in millions**
Number of units (percent affordable)

1985 Bay Area Total
**$1,278.4 million issued**
18,656 units financed
(24% of those affordable)

*Sources: California Debt Advisory Commission; Bay Area Council*

*Despite concerns about overbuilding, the availability of financing, and tax reform, most developers remain optimistic.*

# THE OUTLOOK FOR THE FUTURE

It is clear that in the mid-'80s, the Bay Area's rental housing market is in the healthiest state seen in more than a decade. But, noted the Council's 1985 report, "*this recovery is an extremely fragile one, dependent on a combination of factors ...extremely vulnerable to change on both the economic and the public policy fronts.*" One year and some months later, those changes are already taking shape.

## Continued Developer Interest

Based on a series of in-depth telephone interviews conducted by the Council, developers who have been active in the Bay Area rental market remain generally optimistic about the prospects for rental production in 1987, despite concerns about overbuilding, the availability of financing, and tax reform.

"*The market is definitely softening, and we've seen some slowdown in production, but we fully intend to build more rental projects,*" reports Ron Nahas, partner in Rafanelli & Nahas, which has built 775 rental units in the Bay Area in the last two years, and has 490 more in the pipeline.

"*I'm concerned with overbuilding, but some projects in strong markets are still performing well,*" says John Kerslake, vice president of the mortgage banking firm of Trowbridge, Kieselhorst & Thomas. "*We're going to continue looking at apartment deals, because investors are still seeking good projects in good locations. Our investors are looking at the long-term.*"

Of the 17 major rental developers contacted, 13 said that they will remain involved in the Bay Area market. Local government data seems to bear this out. The 29 jurisdictions surveyed reported that as of June 30, 1986, they had approved (but not yet issued permits for) another 8,430 rental units; some of these projects have already broken ground. In addition, local governments reported receiving proposals for another 10,000 units that had not yet been reviewed.

It is important to note that many of the proposed units may be years away from construction, or may not be built at all, depending on whether approvals are granted, whether financing is available, and whether the developers continue to pursue them. Still, these figures suggest that the Bay Area market does remain attractive to many developers.

## Tighter Project Economics

The economics of rental housing projects will be significantly altered by two factors—the flattening of rents, and tax reform.

In the past, many developers undertook projects on the assumption that rents would continually increase. In the last two years, builders and lenders have been forced to reassess that assumption. The result, says Ron Nahas, is that "*you're going to have to have projects that pencil out at today's rents, and a lot fewer projects are going to pencil out.*"

Tax reform has also altered the framework in which developers and investors make economic decisions. Provisions regarding the write-off of passive losses restrict the opportunity to shelter income in rental housing. In addition, the depreciation period for apartments has been lengthened from 19 to 27.5 years.

Susan Doty, division president of the Bank of America Mortgage & International Realty Corp., agrees that investors are paying increasing attention to the fundamental economics of rental projects. "*Now, instead of looking for tax shelters, people are looking at the product.*"

Some have predicted that tax reform will virtually shut down rental housing production, but according to the Council's survey, most rental housing developers believe construction can continue under the new law. "*Low-cost, quality producers and quality managers will survive in today's market,*" Nahas believes. "*The trick now will be to create value by marrying a good project to a good site. That's the way real estate used to be. In the last few years, you could rent whatever you put up. That's no longer the case.*"

Smaller developers expressed concern about their ability to attract equity participation in apartment projects, since tax reform has diminished some of the advantages of investment in real

estate syndicates. Larger developers voiced less concern, and were already arranging future financing under the new rules.

On one point the developers expressed consensus: fewer projects will pencil out under the less favorable new laws, meaning that tax reform is likely to depress production to some degree, given the current realities of the market. "*We're going to see fewer projects built,*" predicts John Igoe, vice president of Lincoln Property Company. "*But those that do get built will be of higher quality, will be in better locations, and will be better managed.*"

Tax reform will also increase the pressure to raise rents, but in the current cycle of high production and flat rents, property owners and managers are likely to find that difficult.

Generally, most of those interviewed believe the Bay Area holds ample opportunities for rental projects that will make economic sense in the absence of tax advantages. "*Rental housing is still a very good investment,*" says BofA's Doty.

At the same time, developers are well aware of the potential for further change in the rental housing climate. "*The market is good right now, but the environment is somewhat tenuous,*" says Peter Lunt, senior vice president of Oxford Development Enterprises, Inc., a major national developer that has been active in the Bay Area. "*If you saw interest rates go up one or two points, apartment construction might come to a halt.*"

## Concerns with Overbuilding

The recent surge in rental production and rise in multi-family vacancy rates has raised red flags about the potential for overbuilding.

Yet, when viewed in a national context, the Bay Area multi-family market, with vacancy rates pegged at 2.3 percent for 1985, still appears relatively tight. Economists traditionally have viewed a 4 percent to 6 percent vacancy rate as "normal"; only at 8 percent to 10 percent are vacancy levels usually seen as dampening new construction.

"*Bay Area apartment owners have been spoiled by a market that had a limit on supply,*" comments Hank Baker, project director for Bayside Village Associates, local arm of a national development firm. "*Now, with increased construction, people are complaining about softness of the market. But in comparison with national vacancy rates, the Bay Area looks quite good.*"

Of the developers interviewed by the Council, only two felt the Bay Area as a whole has been overbuilt. Some developers voiced concerns that too many projects were being built in some specific markets, with Santa Rosa and parts of Santa Clara County among the most frequently mentioned. But, comments Susan Doty, "*there are pockets within the Bay Area where demand is still good, even in overbuilt markets.*"

It is important to note that signs of overbuilding may reflect intensified competition in one particular economic segment of a market—usually, too many units targeted to affluent renters—rather than a general oversupply of apartments. "*New product is priced quite high, while the real demand is for lower-cost apartments,*" says Rick Holliday, vice president of BRIDGE Housing Corporation, a regional non-profit developer. "*Because of high land values and the cost of financing, most builders are building for the top third of the market.*"

"*Rents are high,*" agrees Charles Oewel, executive vice president of Oxford Development Enterprises, Inc. "*With the constraints of high fees and land costs, we just can't build apartments any cheaper.*"

The best test of the market is absorption rates—how quickly new apartment projects are rented. Comprehensive absorption data does not exist, but anecdotal evidence and reports from developers suggest projects are not filling up as quickly as in the past. Advertising and promotions are more common than they were two years ago. However, instances of serious absorption problems or failed projects are rare, suggesting that the Bay Area rental market is, if no longer red-hot, still quite strong.

*The new tax laws won't shut down rental production, but it's clear that fewer projects will pencil out.*

*If some subregional markets are less attractive than in the past, in other communities demand remains strong and supply limited.*

## A Search for New Sources of Financing

At this stage, lender and investor perceptions of the market are less than clear-cut. Some industry sources already cite reports of lender "nervousness" about rental housing projects and the potential for overbuilding in the Bay Area.

"*Lenders are more cautious in general on all income properties,*" agrees John Kerslake. "*Everybody's gotten conservative because of a prevailing softness in the real estate market in general.*"

At the same time, the rental housing projects in the Bay Area are still attractive in comparison to office and commercial projects, and to residential markets in most areas of the nation.

All the developers interviewed agreed that securing financing from conventional lenders has become more difficult. The larger builders were confident of finding equity partners among large institutions such as insurance companies and trust funds, but only for "blue-chip" projects in "Grade-A locations". Smaller developers were uncertain how they would finance projects in the future, and were far more skeptical about the prospects for financing. "*In the current environment, lenders are looking more at the financial strength of the developer than at the real estate deal itself,*" observes Hank Baker.

Larger developers who prefer not to enter into joint ventures with major institutions are likewise faced with a tight supply of equity capital. "*We've definitely slowed down our production of rental housing in the last six months,*" says John Brezzo, partner in Davidson, Kavanagh & Brezzo, "*chiefly because of the loss of financing through syndications, and the lack of other sources of capital financing.*" One of Northern California's larger residential developers, Brezzo's firm has shifted its focus to single-family homes and townhomes, rather than go the joint-venture route on rental housing.

The investment community is already starting to step into the breach, however, with new real estate investment mechanisms designed to fit the new tax laws. Along with other types of real estate ventures, rental housing is increasingly becoming "securitized" through vehicles such as the REMIC, or Real Estate Mortgage Investment Conduit, that package projects for individual investors. The "master limited partnership" is another new investment structure that responds to the overhauled tax system.

Whatever the future investment climate, it is certain that one major source of financing for rental housing—tax-exempt bonds—will be greatly diminished starting in 1987. The new federal tax law limits each state to an annual indebtedness of $75 per capita for *all* tax-exempt bond issues for industrial development and housing. In California, the new restrictions translate into a ceiling of $1.9 billion. Yet in 1985, local governments in California issued $4.5 billion in bonds for rental housing alone. Even if the state's entire bond allotment were used for rental housing—which it clearly won't be—available financing would be drastically cut back.

Almost all the developers contacted by the Council have made use of tax-exempt bonds; they gave mixed assessments of the future practicality of bonds, in light of stricter affordability restrictions imposed by new federal regulations. Now, either 40 percent of bond-financed units must be occupied by families earning no more than 60 percent of median income in the area, or 20 percent of the units must be occupied by families earning no more than 50 percent of median income (adjusted for family size).

Coupled with declining market interest rates, these new restrictions will likely make bond financing less attractive to rental housing producers. Some stated that "bonds are dead;" others took a wait-and-see attitude. As one builder commented, "*The tax changes will lower our expectations—we'll have to run the numbers to see how much.*"

The changes in the tax-exempt bond program and in the investment climate mean that developers will have to be more creative in seeking financing. Rather than being able to rely on bonds and traditional bank or S&L loans, they will need to plumb sources such as

insurance companies and pension funds. Large institutional investors have put greater emphasis on real estate in recent years, and with the overbuilding of commercial markets, have become more interested in rental housing.

Taxable government bonds are another candidate for future financing, but won't be attractive until the State of California passes legislation to enable and clarify their use.

## Some Weakening of Demand

Any discussion of overbuilding must also consider the demand side of the equation. In the short term, two factors are combining to reduce demand in some segments of the rental housing market. First, due to the high cost of land and high rent levels in the Bay Area, many developers are targeting new apartments to the most affluent renters, a relatively small and shrinking market sector. Especially in some subregions, the supply of high-cost apartments is greater than demand. At the same time, relatively low interest rates are making it easier for more affluent renters to cross over into the homeowner market.

In the longer term, demographic factors may also work to reduce rental housing demand. The Bay Area's demographic structure clearly shows the population bulge composed of those born between 1945 and 1960 (*see Figure 4*). The first in this age group are now past 40, most are in their 30s, and those at the tail end are now 25 or older. When they reached the age of household formation, these "baby-boomers" generated a huge demand for rental housing, but now they are making the move to homeownership in large numbers, and the next generation cannot fully compensate for this drop in rental housing demand. In the next five years, the number of Bay Area residents 20 to 30 years of age will drop by almost 70,000.

Yet, factors other than demographics will come into play. Another upward spiral in interest rates or home prices would keep more people in the rental market, creating demand for a type of rental housing which has more amenities and is more conducive to long-term tenants.

The overall aging of the population is also likely to mean more housing demand by those over 65. In 1990, more than 12 percent of the population will be over the age of 65, and by the year 2000, an additional 100,000 people will have passed the 65 mark. It remains to be seen how much of the housing demand generated by this age group will be for rental housing.

## Focus on Selected Submarkets

While a regional view is necessary to understand large-scale housing trends, those who build new apartments look at markets on a subregional level. And indeed, the Bay Area's subregional markets vary considerably in rental housing demand, supply, and cost. Even if some portions of the Bay Area rental market appear less attractive than in the past, in other communities demand remains strong and supply limited.

"*We still see spots in the Bay Area that look very good for rental housing*," says mortgage banker John Kerslake, who bases his evaluation on factors including job growth, population growth, and special advantages such as access to BART.

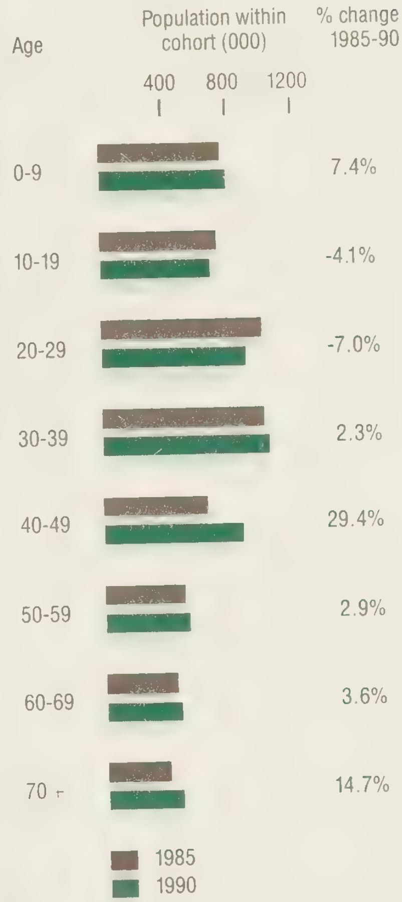
"*We are very, very market-conscious*," says John Wyro, partner in Perma-Bilt Homes. "*We are looking at premium locations only, and at specialized markets such as senior housing*."

It does seem clear that in the future, the continuing trend toward suburbanization of employment opportunities will create new demand for rental housing in certain submarkets, regardless of the supply/demand picture for the region as a whole.

"*The pent-up demand for rental housing has been met*," comments Charles Oewel. "*Now we're building for workers who are moving to new locations. That's a tremendous source of demand*."

Areas such as the San Ramon-Pleasanton-Livermore corridor, where employment is expected to double in the next 15 years, lack a stock of older housing that can serve as affordable shelter "*We've seen a continuing increase in applications and inquiries for rental housing development ever since office buildings went up in Pleasanton*," says Pleasanton's principal

Figure 4
**Age Structure of Bay Area Population**




*Source: California Department of Finance*

*With tighter project economics and the cap on tax-exempt bonds, our needs for affordable housing cannot be met through market mechanisms alone.*

planner Chandler Lee. Marin and San Mateo Counties are other areas that have seen significant economic development but little apartment production. Developer Ron Nahas also sees good opportunities for rental development in older urban areas that were passed over in the recent boom.

## Continuing Affordability Problems

Having been stable for two years, Bay Area rents are likely to remain level in the near future. But the prospects for any significant decline in rents are slim. As a consequence, low-income households will continue to find a dearth of units they can afford.

Particularly in light of tightening project economics and the low cap on tax-exempt bond financing, affordable housing needs cannot possibly be met through market mechanisms alone. Federal, state, and local-level action remains essential.

At the moment, the best hope for production of affordable housing lies in local action to capitalize on the new tax-exempt bond provisions and the new federal low-income housing tax credit, both enacted as part of the Tax Reform Act of 1986.

Because affordability requirements for bond-financed projects have been made stricter, those projects that do qualify will provide more affordable units than in the past. However, apartment developers have expressed doubts about whether bond-financed projects will pencil out. It is clear that the new bond program will produce fewer Bay Area projects than the old one, and additional subsidies may be required for the projects that are undertaken. Local government action, in the form of land write-downs, density bonuses, and fee waivers, may be necessary for such projects to work. The City of Fremont, for example, has secured authority to issue a 1986 tax-exempt bond under the new tax law to finance a privately developed rental housing project granted a 25 percent density bonus by the city.

The new federal tax credit for production and rehabilitation of low-income rental housing provides for a 10-year annual credit worth up to 9 percent of construction costs and 4 percent of acquisition and rehabilitation costs. However, the program is subject to several restrictions. The portion of units that must be set aside as affordable housing is the same as under the tax-exempt bond program. The program is also subject to a state-level cap of $1.25 per capita annually, or approximately $29.6 million for the entire state of California. This would limit the resulting development to roughly 7,000 to 11,000 units statewide per year. (If the credit is combined with tax-exempt bonds, the annual credit is limited to 4 percent of costs, but the project is exempt from the volume cap.)

Due in part to the strict targeting requirements, few of the Bay Area developers contacted by the Council expressed an interest in the credit. "*It might work in Tulsa, but not here,*" observes John Igoe of Lincoln Property Company. "*The incentive is not that great.*" The credit may be more useful to non-profit developers who combine it with other types of subsidies.

## Dependence on Local Initiative

The federal housing budget has been cut from $31 billion in 1981 to $11 billion in recent years, and thus far, state funding has not been available to help fill the gap. Rather, since the late '70s the California Legislature has enacted a number of measures vesting local government with much of the responsibility to encourage production of affordable rental housing.

A recent study which was commissioned by the California Department of Housing and Community Development concluded that "*the effectiveness of all the state laws concerned was found to depend much more on each local jurisdiction's predisposition toward the development of affordable housing than on the existence of state laws or on any attempts to enforce them.*"

While some new federal and state laws reflect awareness of the affordability problems many renters face, it is clear that, at least for the next few years, it will be up to local governments to see that available tools are used effectively.

# DIRECTIONS FOR ACTION

In the mid-'80s, the Bay Area has approached the rate of rental housing production that, if sustained, would meet a good share of the region's long-term needs. But it is too soon to consider rental housing problems solved. The Bay Area is still in a "catch-up" mode after the lean production years of the late '70s and early '80s. The upswing in housing production resulted from a combination of factors that are already changing. It is by no means certain that the current rate of production can be maintained.

The most important point is that continued rental production alone wouldn't solve affordability problems—though an expansion of supply has eased costs for renters as a whole. Even with the peak construction levels and favorable financial conditions of recent years, relatively few of the new units developed are affordable to low- and moderate-income households. Virtually none are affordable to very low-income households.

While continued expansion of rental housing supply is needed to meet the region's long-term needs, and to help moderate future rent increases, special efforts are needed to spur production of units that are truly "affordable" to less affluent renters.

The direction of federal policy makes it clear that the responsibility to pursue rental housing goals rests squarely upon state government and upon local government and housing advocates, working together with for-profit and non-profit developers. The fact that the climate for rental housing production is still relatively favorable presents an opportunity upon which all concerned should capitalize.

## Favorable Land-Use Policies

Designating land for multi-family housing is an important step to replenish the region's supply of available sites, and prevent rapid escalation in the price of such land. Local governments should explore the potential to rezone commercial land (of which there is a regional oversupply) and other types of parcels for multi-family housing.

Bay Area communities should also be aware of ways in which the changing economic climate will affect the type of rental housing developed in the future. Tax reform and the shift to new sources of financing will favor larger-scale developers and projects, while making it more difficult for smaller developers to compete. To encourage rental housing production, it will be necessary that communities either designate sites suitable for larger-scale projects (or assist in the assembly of smaller parcels), or else take steps to assist smaller and non-profit developers.

The potential to encourage new housing development is greatest in markets where demand is high, including urban areas such as San Francisco, new job centers such as Pleasanton, downtown San Jose, and San Ramon, and centrally located markets that have seen relatively little rental production, notably Marin and San Mateo Counties.

## Incentives for Affordability

In the past, many communities have relied largely upon the tax-exempt bond program to spur production of affordable rental housing. But due to new restrictions on the program, bond financing is no longer in itself sufficient incentive for development of affordable rental units.

Project economics have become generally tighter, meaning that now more than ever, actions taken by local government can play a critical role in the feasibility of new rental housing. The changing climate also means that non-profit developers will play an even more important role in development of affordable housing.

Local governments should utilize such techniques as land write-downs, fee waivers, and density bonuses to complement tax-exempt bond financing and pursue development agreements calling for inclusion of affordable units. The combination of these techniques with bond financing could produce affordable units with rents even lower

*Now more than ever, local government actions can play a critical role in the feasibility of new rental housing development.*

than were achieved under the old bond program. A special effort should be made to use such mechanisms in support of non-profit developers.

## State Action on Bonds and Tax Credits

The Federal Tax Reform Act of 1986 places strict limits on tax-exempt debt incurred by states, but leaves it to each state to determine how tax-exempt bond authority is to be allocated. California is still establishing its process for the allocation of some $1.9 billion in annual bonding authority among competing uses. The rules adopted to allocate this debt will have profound impacts on the amount, type, and location of rental housing financed with tax-exempt bonds in 1987 and beyond.

State action is also needed to determine how the newly enacted low-income federal housing tax credit is to be allocated within California. Federal law makes available credits of $32 million statewide in 1987.

Finally, the State should move to pursue the potential for use of taxable bonds to finance rental housing, including affordable units. While taxable bonds require payment of higher interest rates than tax-exempt bonds, they can still be attractive if market interest rates are low enough. Moreover, they are exempt from the new federal bond limits and from stringent affordability requirements of the new tax code. A number of cities in the U.S. have already utilized this vehicle; it remains for California to pass legislation enabling its use.

## Improving the Information Base

Better information on rental housing cost and production would help communities identify and respond to those needs. It is still true that most data does not distinguish rental from other forms of multi-family housing. The availability of local rental housing cost data is spotty. Some local governments have taken steps to gain more accurate, regular information on rental housing, among them Vacaville, the City of Santa Clara, and Santa Rosa. Many others have not yet acted to improve data-gathering on rental housing.

**Bay Area policy-makers can play an important role in the continuing production of rental housing to meet the region's long-term needs. They also have a responsibility to address affordable housing needs that can only be met through concerted action by state and local government, housing advocates, and for-profit and non-profit developers.**

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*The Bay Area Council, established in 1945, is a business-sponsored organization dedicated to analysis and action on regional issues. Its program currently focuses on strategic growth and economic development issues, including housing, transportation, and job training.*


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